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Inflation Nation: Should We Worry?

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Today, Hugo and Olga delve into the drivers of prospective inflation. It turns out that central bankers have no influence over the determinants of inflation in an economy and that the experience of the 1970s is no guide for the 2020s.

Hugo Scott-Gall: So, I thought on our walk today we should talk about inflation. What do people mean when they say that we are going to get inflation? High inflation: what would be the level, and for how long? In Q2 of this year, everyone expects U.S. and European CPI to post significant year-over-year gains simply because everything was frozen this time last year. But what about sustainably higher inflation as compared to the 2010s in the medium term?

Olga Bitel: To start, persistent and accelerating inflation occurs when demand grows consistently in excess of supply. What follows directly out of this definition is that supply must somehow be constrained on a structural basis relative to demand for inflation to be high and or rising. This frequently happens in many emerging markets, where supply is constrained by lack of infrastructure, poor access to credit, land restrictions, and various other bottlenecks. By contrast, across virtually all DMs, supply will likely respond to sustainably strong demand growth.

Specifically, 70% of what we consume regularly are services, which is true across all DMs. Prior to the COVID recession, services inflation ran at 3% AR for much of the last decade. Goods inflation was quite low and decelerating. Last year, in the height of lockdowns, the situation flipped such that goods prices began to grow faster on the back of logistical challenges and production closures. At the same time, services price inflation plummeted to below 1.5% AR.

As our economies genuinely reopen and people are allowed to move more freely, the 2020 experience will reverse. The challenges with goods production and longer delivery times will get resolved within months, not years, and goods price inflation will likely return to the pre-COVID muted annual rate of sub-2%. Services prices will likely move sharply higher as restaurants, theatres, and travel reopen. We may even see pockets of quite large price increases, as supply will not be able to adjust instantly to all the pent-up demand, in leisure travel for example. Airlines cannot return 400 more planes on the runways in a week and builders cannot construct 200 more hotel rooms on Miami Beach in a week.

Pockets of much stronger price gains will probably generate headlines, and many holidaymakers may be disappointed with their inability to confirm bookings at any price. But the argument that such isolated, temporary pockets of price pressures will translate into sustained, higher annual inflation in the medium term is weak because it does not consider supply adjustment.

In the medium term, stronger economic growth of around 3% can translate into a sustainable annual inflation rate of 2%-3%. Every policymaker and Main St. shopper would rejoice. The central banks would welcome this outcome with open arms instead of worrying about inflation being too low as a result of weak growth. Much debate today is too quick to dismiss this as a distinct, even likely possibility for the 2020s.

Hugo: Listening to you just now, I thought: “It all sounds so simple, you just get some really good central bankers and then everything is OK.” History shows that that ain’t so, and trying to negotiate inflation is like trying to keep your hands on a snake. Things can get out of control pretty quickly. Let’s go back in history—what happened in the 1970s?

Olga: I remain resolute in my defense of present-day central bankers. They do not manufacture inflation, by definition. They cannot control or even influence either supply factors, many of which we already mentioned today, or the demand factors such as competitive markets, availability of qualified labor, and manageable nonsalary costs, just to name a few. Many were against the policies that led to the stagflation of the 1970s.

Historically, bouts of high inflation result when a government attempts to increase its own purchasing power, usually by suppressing everyone else’s. Whatever the merits of the Vietnam War in the geopolitical sense, it was so unpopular at home that raising taxes to finance it was out of the question. The original mistake of printing a little bit more money to get a little bit ahead to finance various geopolitical adventures that were not popular at home, such as the Vietnam War, then resulted in rising prices and higher wage demands by the unions at home and growing balance-of-payments deficit abroad.

On Sunday, August 15, 1971, the United States unilaterally canceled the convertibility of the U.S. dollar into gold and introduced wage and price freezes, together with surcharges on imports. The following day, Dow Jones

Industrial Average registered a 32.9-point gain—the largest one-day increase up to then. These freezes were supposed to last “only” 90 days. In practice, they dragged on for at least four years, and in the case of energy prices, for a whole decade.

We are all familiar with the oil price shocks of the 1970s. What has been forgotten is that we had at least 32 different prices of natural gas and several tiers of oil prices that were in effect for a decade. These policies forced domestic producers to subsidize imported oil. So, by the time of the second oil price shock, the adverse impact on the U.S. economy is estimated to have been at least three times larger compared to the 1973 episode.

And the price distortions did not end in the energy sector. The price of poultry was regulated, but the price of grain feed was not. It became so unprofitable to raise chicks that farmers began to drown them, and severe poultry shortages with corresponding skyrocketing prices were the result. To circumvent price freezes, contractors drilled holes in plywood and immediately filled them back up to create a customized product. Builders shipped lumber to Canada only to import it again. Grocers invented new cuts of beef, so that it would fall outside of announced price controls. Faced with wage freezes, workers across many industries began to strike; social unrest was rife on both sides of the Atlantic.

The bottom line is that the calamitous experience of the 1970s had much to do with egregious macroeconomic meddling, and inflation did not appear suddenly out of nowhere. Misguided price controls and wage freezes disincentivized supply adjustment and destroyed demand growth. The 1970s bear no resemblance to what we are talking about today: stronger demand growth, employment, and supply adjustment and more stable, mild inflation consistent with price stability, broadly defined.

Hugo: So, economic mismanagement schemes for political gains are a thing of the past in the developed world. Nobody is talking about price controls or dictating to consumers where to spend. You are now saying, “We have worked out how to manage our economies.” If Minsky was here, would he argue that our confidence is just stirring up trouble? Are we taking on a lot more risk, underappreciated risk?

Olga: I love how we jump so many months and years ahead. And yet, MOFAR is only just beginning. Let’s see how our economy reopens, how supply adjusts, how investment policies move from vague political promises to delivered projects. Rather than brimming with confidence, much of the discourse has focused on risk, as if in search of the next big short. I’d say our Minsky moment is some way off in the future.

Have you been following the most recent change of government in Italy? This perennial problem child actually experienced a change of government because they wanted to make sure that they have the systems and mechanisms in place to actually invest all the money that will be available to them through the EU funds over the next two to five years. Have we ever had a debate as a society about how to smartly invest large amounts for our future growth? This is exciting stuff.

Hugo: So, it looks like we may have stronger economic growth and maybe even higher inflation. Each of these point to higher interest rates. We know that asset prices are very sensitive to real interest rates. We know that long duration assets like equities are very, very sensitive to real interest rates and changes in them. What do you think this new era means for different asset classes and within equities specifically? But it is a longer conversation and let’s save that for our next walk. We’ll make it a particularly hilly walk perhaps.

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